

VZCZCXRO7051
RR RUEHCN RUEHGH
DE RUEHGH #0550/01 3510537
ZNR UUUUU ZZH
R 160537Z DEC 08
FM AMCONSUL SHANGHAI
TO RUEKJCS/SECDEF WASHINGTON DC
INFO RUEHHK/AMCONSUL HONG KONG 1779
RUEHGP/AMEMBASSY SINGAPORE 0193
RUEHGH/AMCONSUL SHANGHAI 8042
RUCPDOG/USDOC WASHDC 0233
RUEHRC/DEPT OF AGRICULTURE WASHINGTON DC
RUEHC/DEPT OF LABOR WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUEHBJ/AMEMBASSY BEIJING 2360
RUEHGZ/AMCONSUL GUANGZHOU 0071
RUEHCN/AMCONSUL CHENGDU 1612
RUEHSH/AMCONSUL SHENYANG 1604
RUEHIN/AIT TAIPEI 1405

UNCLAS SECTION 01 OF 04 SHANGHAI 000550

SENSITIVE
SIPDIS

STATE FOR EAP/CM
TREASURY FOR AMBASSADOR HOLMER, WRIGHT AND TSMITH;
TREASURY FOR OASIA/INA - DOHNER, HAARSAGER/WINSHIP;
TREASURY FOR CUSHMAN
TREASURY FOR IMFP SOBEL. MOGHTADER
NSC FOR WILDER AND LOI
STATE PASS CEA FOR BLOCK
STATE PASS USTR FOR STRATFORD/WINTER/MCCARTIN/KATZ/MAIN

E.O. 12958: N/A

TAGS: [CH](#) [EFIN](#) [ECON](#) [PGOV](#)

SUBJECT: (SBU) EXPORT SLOWDOWN SPURRING BANK REFORMS IN ZHEJIANG

1. (SBU) Summary. Zhejiang provincial and local officials are pushing ahead with financial reforms to create small lending companies as part of their answer to the global financial crisis. Our contacts described the need to increase financing for SMEs as critical because bank lending to SMEs has dried up. In terms of corporate governance, the pilot projects are well designed. However, the new policies on small lending companies are unlikely to have a great impact on increasing funding to SMEs in the short term. Neither will the experiments go far in bringing Zhejiang's informal banking activity into the open. End summary.

=====
Zhejiang Pushing Ahead with SME Financing Reforms
=====

2. (SBU) Zhejiang provincial and local officials are pushing ahead with financial reforms to create small lending companies as part of their answer to the global financial crisis. With slowing export growth and broader macroeconomic troubles weighing on the province's many small and medium-size enterprises (SMEs), Zhejiang officials and entrepreneurs have jumped at the chance offered by Central Government regulators to bring some of the informal banking system out into the open.

3. (SBU) Zhejiang has been in the forefront of responding to the call for small lending company pilot projects issued on May 4, 2008 by the China Banking Regulatory Commission (CBRC) and the People's Bank of China (PBOC). According to an article posted in July 2008 on the State Council's website Zhongguo Wang, Zhejiang is taking the lead in the pilot project. Hongda Small Lending Company, located in Ningbo, was the first project, opening for business on September 28. Nonetheless, several other provinces have also recently announced plans to set up small lending companies, including Beijing, Chongqing, Fujian, Hebei, Jiangsu, Shandong, Shanghai and Fujian.

=====
The View from Zhejiang
=====

14. (SBU) Zhou Yeliang, PBOC Hangzhou Subbranch president, told Econoff during a November 19-20 visit to Hangzhou and Wenzhou that as of November 19 the province had received 40 applications to establish small lending companies to date, of which 25 had been approved and 10 were already open for business. Zhou said that the province intends to reach its full complement of 110 small lending companies "soon." According to the Zhongguo Wang article, Central Government authorities have approved Zhejiang's plan to establish one small lending company in each county, with an additional four in the cities of Jialing, Hangzhou, Taizhou, and Wenzhou and one additional small lending company in Yiwu.

15. (SBU) Small lending companies are not considered financial institutions for regulatory purposes, agreed our Zhejiang contacts. Therefore, as spelled out in the May 4 CBRC/PBOC guidelines, they are not monitored by the local CBRC branch, but rather the local Bureau of Industry and Commerce, while approvals for applications are at the discretion of the local financial affairs office or equivalent. This process was followed in the application of Chen Kaiyuan, founder and chairman of Cangnan Lianxin Small Lending Company in Wenzhou, which he claims is the first operating small lending company in Zhejiang. Chen told Econoff on November 20 that Cangnan County officials approved his application on August 20, city-level at the end of August, and provincial-level officials on September 24. Following that, the firm's capital was injected on October 7, the company was officially registered with the provincial Bureau of Industry and Commerce on October 13, and the firm began conducting business the same day.

=====

SHANGHAI 00000550 002 OF 004

Officials Hoping Reforms Will Help SME Liquidity . . .

=====

16. (SBU) Our contacts described the need to increase financing for SMEs as critical because bank lending to SMEs has dried up. Hangzhou PBOC's Zhou said that Zhejiang "has SMEs as a target for monetary policy." Provincial officials want to increase the new investment going to SMEs, and "small lending companies will be a big help," he said. Zhou, however, vigorously denied that the Central Bank had issued any quotas for banks' lending to SMEs -- the dropoff in lending growth to SMEs earlier this year was an artifact of high lending in the year-earlier period, he stated.

17. (SBU) Two main reasons were cited by most interlocutors for SME financing problems: First, banks are being much more cautious in lending to riskier small and newly established firms in the current economic conditions. Pan Guangen, director of the banking affairs department of the Zhejiang Provincial Government Financial Affairs Office, said that banks don't want to extend credit to SMEs because they are afraid their nonperforming loan ratio will rise. Second, the main commercial banks are too focused on large customers. The large banks' fears are worsened by their inability to get to know the details of smaller companies' businesses, said Pan. Hangzhou PBOC's Zhou made a similar point, although perhaps one more influenced by a planned-economy approach to banking, saying that big banks are intended to finance large companies and infrastructure, agricultural credit cooperatives should finance farmers, and the small lending companies could finance SMEs and startups.

=====

. . . But Acknowledge There Is Little Impact So Far

=====

18. (SBU) In their initial stage, the new policies on small lending companies are unlikely to have a great impact on increasing funding to SMEs, our contacts agree. The main problem is the scale of the pilot project. Even at an eventual strength of 110 small lending companies, registered capital for each ranges only from RMB50 million to RMB200 million, for a total province-wide available capital pool of RMB5.5 billion to

RMB22 billion (approximately US\$803 million to US\$3.2 billion). Lending in Zhejiang in 2007 was RMB2.85 trillion (approximately US\$416 billion), according to the PBOC's Zhou, so the new channel will amount to much less than one percent of total lending.

=====

Small Step in Legitimizing Informal Finance

=====

¶9. (SBU) The experiments will also not go far in bringing Zhejiang's informal banking activity into the open, said Shi Jinchuan, Executive Dean of the Zhejiang University's College of Economics. Shi told Econoff that a conservative estimate of total private finance in Zhejiang Province would be RMB800 billion to RMB1 trillion (approximately US\$117 billion to US\$146 billion). Shi also said that the threshold of RMB50 million for small lending companies' registered capital was too high. Rather than set standards that serve to keep players out of the finance markets, said Shi, the PBOC should focus on monitoring and surveillance.

¶10. (SBU) Zhou Dewen, President of the Wenzhou SME Development and Promotion Association, made the more aggressive estimate of RMB600 billion (approximately US\$88 billion) for private financing in Wenzhou City. This dwarfs the RMB1 billion (approximately US\$146 million) that could be channeled through Wenzhou's allotted five small lending companies. (Note: The PBOC Hangzhou's Zhou was highly critical of Zhou Dewen's private finance estimates, saying that Zhou Dewen surveyed only small

SHANGHAI 00000550 003 OF 004

firms that rely most heavily on private finance and then extrapolated to all enterprises. Zhou in a recent press interviews has defended his estimate, qualifying it to say that RMB300 billion is invested locally and another 300 billion is invested elsewhere in China and abroad. End note.)

¶10. (SBU) Nonetheless, the first companies have been welcomed by SME's in Zhejiang. Lianxin Small Lending Company's Chen told Econoff that most of his RMB100 million in registered capital was lent out within the first week of business. More than 70 percent of his loans are for RMB500,000 (as mandated by the regulations), said Chen, and are for short-term bridge loans tied to receivables or to the period needed to roll over bank loans. Lianxin as of November 20 had already turned over its entire capital at least once, said Chen.

=====

Trying to Align Incentives with Good Corporate Governance

=====

¶11. (SBU) Borrowers are motivated to access finance through the new channel because interest rates are slightly reduced by regulatory caps. Generally, short-term rates from informal lenders can reach 3 percent a month, although such high rates generally apply to periods of just a few days, said Bao Ji, Office Director of the Wenzhou City Clothing Chamber of Commerce. Lianxin Small Lending Company, on the other hand, lends at 1.2 percent a month for rural borrowers that are part of the Central Government's rural policies, at 1.2 percent for "normal" borrowers with collateral, and at 1.6 percent-1.8 percent for noncollateralized loans guaranteed by third parties. Chen said that 70 percent of Lianxin's loans fall into the latter category. The PBOC Hangzhou's Zhou and the Zhejiang Financial Affairs Office's Pan said that rates are currently capped at an annual rate of 20 percent; however, Zhou and others said that in principle the upper limit would be four times the PBOC's base lending rate. (Note: The Supreme People's Court has established interest rates above this level as illegal usury. End note.)

¶12. (SBU) Small lending company shareholders are motivated to properly manage their finances by the promise that they could eventually gain a rural banking license, said Lianxin's Chen. Central and local officials are dangling the prospect that small

lending companies with a record of adding to the social good and operating within the rules could at some future point apply to become a rural bank. Chen, who is also the founder and chairman of a mid-size gas valve producer, reflected this policy by saying that one goal in establishing Lianxin was to support SMEs that are struggling just like his own company did in the 1990s to get a start. However, there are also signs that the current incentive structure may not preclude all efforts by shareholders to use small lending company finances to self deal. Chen, for instance, admitted that he sees Lianxin as a potential channel to help fund his own business. (Note: Chen did not mention if he would thereby run afoul of regulations that appear to prohibit this. See below. End note.)

¶13. (SBU) Despite the careful planning, the experiments may only take hold in limited areas of Zhejiang province. Zhejiang University's Shi predicts that the pilot projects will find fertile ground in growing mid-size cities like Wenzhou, Taizhou, Jinhua, and Yiwu, where private finance is already common. Shi told Econoff that in more prosperous cities such as Hangzhou and Ningbo, businesses turn more frequently to banks, while in poorer areas, there is much less demand for capital.

=====
Strict Controls for Small Lenders During the Trial Period
=====

¶14. (SBU) The PBOC Hangzhou's Zhou and the Zhejiang Financial SHANGHAI 00000550 004 OF 004

Affairs Office's Pan both averred that several factors will assure that small lending companies do not destabilize financial markets:

-- Investors in the small lending companies are strictly vetted. The lead investor cannot control more than 20 percent of the firm's capital, and the other investors cannot control more than 10 percent each. Investors must have a history of good corporate governance and social responsibility. And investors should have debt ratios of no more than 70 percent, have net assets of greater than RMB50 million, and net profits of more than 15 million for three years.

-- Small lending companies are encouraged to partner with banks, which provide additional oversight. A small lending company can borrow up to an additional 50 percent in capital from a bank, which gives the bank incentive to assure the small lending company is engaged in prudent lending practices. In addition, Lianxin's Chen noted that small lending companies' loans are channeled through bank accounts, providing transparency.

-- Small lending companies are not allowed to be overexposed to a single borrower. Seventy percent of loans must be in the range of RMB500,000.

-- Small lending companies are not allowed to take deposits, thereby limiting the impact of any potential bankruptcy on average citizens. Zhou emphasized strongly that any small lending company found to be taking deposits will be shut down.

-- Small lending companies are restricted to lending to companies within the county where they have been established, said Lianxin's Chen.

¶15. (SBU) In addition, Lianxin's Chen said that he was required to submit frequent financial reports to the local Finance Bureau and Bureau of Industry and Commerce. Initially, said Chen, the reports were required almost daily, but over time the reporting period will be relaxed to monthly.

=====
Comment
=====

¶16. (SBU) The pilot projects to establish small lending companies appear to have more propaganda value than actual

substance at present, and are even less likely to have much utility in overcoming the macroeconomic factors weighing against Zhejiang's SMEs. Broadly speaking, however, the support from the Zhejiang provincial government for the pilot projects, along with the strong demand for the small lending company services in some localities, indicates that Zhejiang authorities may make some limited progress on their motto of confronting the current economic crisis while encouraging reforms.

¶17. (SBU) The alignment of incentives in the pilot program would appear to mitigate the potential for corruption and self-dealing, although this cannot be guaranteed given the reportedly severe capital constraints that firms in Zhejiang are facing. In any case, the structure limits the social stability impact of malfeasance by placing a high threshold for investors.
CAMP